Central Intelligence Agency

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

27 August 1984

Mr. Donald B. Kursch
Deputy Director for Economic Affairs
Office of Soviet Union Affairs
Department of State
Washington, D.C. 20520

Dear Mr. Kursch:

The enclosed memorandum contains our analysis of issues relating to Soviet gas pricing and export strategy raised in paragraph 4 [redacted] We hope that our comments will be useful to the US Mission. At the discretion of the Department, the content of the memorandum is releasable to the NATO committee. 25X1

If we can be of further service in this matter, please call [redacted] 25X1

Sincerely,

[redacted] 25X1

Chief
Soviet Economy Division
Office of Soviet Analysis

Attachment:
As stated.

SOVM84-10143/84

CONFIDENTIAL [redacted] 25X1

Soviet Gas Pricing and Export Strategy

A Memorandum Addressing Issues Raised in an Inquiry
from the US Mission to NATO.

Central Intelligence Agency
Office of Soviet Analysis
Soviet Economy Division
27 August 1984

SOVM84-10143/84

Soviet Gas Pricing and Export Strategy

Background

A recent Oil and Gas Journal article (23 July 1984) speculates that the USSR might trigger a gas price war in Western Europe in order to achieve full utilization of the new Urengoy-Uzhgorod export pipeline, lower its operating costs, and maximize hard currency profits. The recent Soviet offer of a discounted price to Belgium's gas utility (Distrigaz), reportedly 15 percent below the price of Dutch gas then being supplied by the Netherlands' gas utility (Gasunie), lends currency to this speculation. It is further suggested that French, West German, and Italian customers may press the Dutch for similar price reductions. The NATO Economic Committee has raised questions as to the Soviets' reliability as an energy supplier and as to their marketing strategy. There is an underlying concern that predatory pricing policies could forestall development of more secure (i.e., Norwegian offshore) alternatives to Soviet gas once West European demand recovers and existing supply contracts begin to expire after 1992.

This memorandum discusses the Soviets' recent gas pricing behavior in the soft West European market (the offer to Distrigaz and implications for negotiations with other West European buyers) and analyzes the outlook for longer-run Soviet gas pricing and export policy. Before examining the questions of Soviet market behavior and options, it is useful to review the USSR's traditional export strategy and pricing policy. The following judgments can be made for the post World War II period:

- Foreign trade and export policies usually have been structured to achieve hard currency goals and make possible the purchase of Western goods and services for the domestic economy.

- All contract sales agreements with the West are monitored closely, and Soviet performance has been exemplary. The Soviet adherence to contractual obligations has been widely acknowledged in the market.

- The Soviets take a long-term approach to foreign trade in energy because of their limited influence in the market. They are, however, astute market analysts and quick to exploit changing market trends.

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- o Soviet marketing and pricing policies are pragmatic, flexible, and quickly adapted to short-term market fluctuations in order to meet hard currency revenue goals. In other words, contract volumes and prices can be renegotiated when justified by unforseen developments.

Recent Gas Negotiations with Belgium

Recent press accounts of a Soviet offer to sell gas at a discount to Belgium's Distrigaz largely overlook the lingering "softness" of the market for both natural gas and oil in Western Europe. As early as last February, for example, French gas prices to industrial users were at least 18 percent below the price of fuel oil on a comparable BTU basis, according to the press. In June, the Belgians could not compete with French or Dutch ammonia producers, who were enjoying a 12 to 15 percent price discount from Gaz de France and Gasunie, the Dutch gas exporter. Gasunie, a major gas supplier to both France's Gaz de France and Belgium's Distrigaz, was reluctant to lower the price of gas sold to Belgium when asked to do so. The Soviets, however, offered cheap gas for the Belgian fertilizer producers on a "spot" market basis. The Soviet offer to Belgium's Distrigaz, which specified a 15-percent discount for 0.5 billion cubic meters (m^3) of gas to be delivered over a 2- to 3-month period, may have forced Gasunie's hand. Distrigaz eventually obtained the desired gas at a discounted price from Gasunie, but first had to develop a credible Soviet alternative. At the same time, the Soviets may well have allowed themselves to be used. If they were to compete in the soft market, they were obliged to not only match the low prices prevailing in gas sales to industry but also the discount to ammonia producers.

There have been numerous media accounts of Soviet discounting on "spot" market sales of oil and gas to West European buyers since late in the first quarter of 1983, when discounting by OPEC members flourished before the cartel's $5.00 per barrel price cut. Soft market conditions for the sale of gas in Western Europe reflected depressed economic activity, unseasonally warm winters in 1982-83 and 1983-84, energy conservation measures, and the relationship between oil and gas prices. Throughout this period, the USSR was forced to price gas exports about 15 percent below competing fuel oil on a BTU equivalent basis. Total gas exports to the West, as well as the associated revenues, actually declined in 1982 and 1983 (see the table).

Most West European gas prices were indexed to oil prices following the 1973-74 Arab oil embargo. Because of the lag in application of the indexing formula, gas prices increased at a much slower rate than oil prices during the two OPEC price run-ups in 1974-81. When oil prices began to fall in late 1982, gas prices once again followed. Over the last 18 months, changes in official gas prices usually lagged those for oil by 3-6 months and seldom reflected the lower prices posted in "spot" market

Soviet Gas Exports,
1980-90

	Volume (billion m^3)					
	1980	1981	1982	1983	1985[e]	1990[e]
European Communist Countries	31.5[e]	32.2	33.8	34.3	42.0	55.0
Eastern Europe	30.0	30.0	30.8	37.0	38.5	50.0
Bulgaria	4.6	4.5	4.5	5.5	6.0	8.0
Czechoslovakia	8.3	8.5	9.0	11.1	11.0	11.0
East Germany	6.5	6.4	6.5	7.8	8.0	10.0
Hungary	3.8	3.8	3.7	4.5	5.0	6.0
Poland	5.3	5.3	5.6	6.0	6.5	11.0
Romania	1.5[e]	1.5	1.5	2.1	3.0	4.0
Yugoslavia	1.5[e]	2.2	3.0	3.3	3.5	5.0
Total Revenue[1]						
(In million rubles)	1,564.4[e]	2,082.6	2,695.7	3,865	4,733.8	6,197.4
(In million dollars)	2,098.0[e]	2,791.0	3,612.0	5,179	6,342.0	8,304.5

	Volume (billion m^3)					
	1980	1981	1982	1983	1985[e]	1990[e]
West European Non-Communist Countries	25.0	28.6	28.5	25.4	37.0	55.0
Total NATO	21.7	24.6	23.3	21.5	32.0	49.0
France	4.0	4.7	4.2	4.0	8.0	12.0
Italy	7.0	8.1	8.6	7.5	9.0	15.0
West Germany	10.7	11.8	10.5	10.0	15.0	22.0
Austria	2.4	3.2	4.4	3.2	4.0	4.6
Finland	0.9	0.8	0.8	0.7	1.0	1.5
Total Current Revenue (In million dollars)	2,478.7	3,939.5	3,655.9	3,248.0	4,092.0	7,033.2
Average Unit Price (US dollars (per million BTU)	2.81	3.90	3.63	3.62	3.62	3.62

1 All current revenues in rubles were revalued at $1.34 per ruble for purposes of comparison. Constant 1983 prices were assumed in estimating 1985 and 1990 revenues from export contracts now in force.

e CIA estimate.

sales. In a depressed market, buyers of both oil and gas tend to postpone delivery of contracted sales and switch to the "spot" market for cheaper gas and oil supplies. Once seasonal inventories exceed requirements, both fuel oil and crude oil are apt to be dumped at distress prices. Distress prices for fuel oil tend to drive down gas prices, further reducing demand for oil and setting off a chain reaction. West European refiners have reacted by using underpriced fuel oil for up to 10 percent of total refinery feedstock and thereby lowering demand for crude oil at the margin.

The Soviets have responded more quickly than the Dutch Gasunie to these changing market conditions. They have temporarily raised and lowered prices for both natural gas and oil as required to meet hard currency revenue objectives from the sale of minimum volumes. By comparison, the going price for Dutch gas is less apt to reflect current "spot" market conditions because of indexation lags.

Renegotiating Gas Prices in a Buyers' Market

The media have noted that, when the long-pending contract for sales of Urengoy gas to Italy was signed, Soviet gas prices to Italy were more than competitive. The Italian press stated that the Soviet gas price was about $125 per 1,000 m^3, ($3.50-$3.60 per million BTUs), which is low enough to undercut the price of fuel oil. Disclosure of this low price prompted speculation that Gaz de France would seek a 10-percent reduction in price, as well as a 20-percent reduction in volume, on its contract for Urengoy gas. West Germany's Ruhrgas was expected to join cause with Gaz de France in these discussions. Obviously the subject was raised with the Soviets, but no formal action is required on their part outside the established semi-annual meetings held in October and April of each year. In the present buyers' market, Soviet restraint is to be expected because reductions in official gas prices also influence the price for Soviet oil--presently a much more important source of export revenue. Soviet oil sales amounted to roughly $15 billion in 1983, about five times the amount of gas revenues of $3.2 billion for that year.

The Soviets have no reason to be a spoiler by instigating a gas price war in the near term. In today's depressed market, a premature announcement of a permanent price cut might trigger a price war between gas and oil that could get out of control. Moreover, if the USSR did cut the price of gas, it would not be able to boost gas export volumes fast enough to offset potential declines in the combined revenues from oil and gas exports. The recent Soviet oil price cut of $1.50 per barrel was intended to give OPEC producers a signal to observe oil production quotas and thereby shore up the price.

Soviet Long-Term Gas Pricing and Export Strategy

Soviet marketing strategy and pricing policy in the future could be radically different from that observed to date. Six years hence Moscow will be facing a much wider selection of options. The ability of the USSR to produce, transport, and sell a vastly increased volume of natural gas at low prices can no longer be questioned. Therefore, there is a real possibility that a Soviet "gas weapon" could be brandished in the 1990s, just as the OPEC "oil weapon" was used in the 1970s.

The Soviet Union has the capability to rival OPEC in terms of natural gas exports in the next decade. The USSR, possessing some 40 percent of the world's gas reserves, is now the world's largest producer of both oil and gas and the world's largest exporter of gas. (In 1983, it surpassed the US in gas production.) Previously, the USSR became the world's largest exporter of natural gas in 1980, when it overtook the Netherlands.

Last year, Soviet gas production reached 536 billion m^3 and 66 billion m^3 were exported, compared with Gasunie's exports of 38 billion m^3. More than 25 billion m^3 of the Soviet 1983 exports were delivered to Western Europe, and that volume will more than double by 1990. Shipments to NATO countries (France, Italy, and West Germany) should increase from over 21 billion m^3 in 1983 to almost 50 billion m^3 in 1990. Beyond 1990, the Soviets' market share could expand sharply when up to 50 percent of Western Europe's gas supply, or 120-130 billion m^3/yr., will be imported and energy dependency will be an issue. France, Italy, and West Germany will be obtaining about 33 percent of their total gas supply from the USSR by 1990. If gas imports from the USSR are increased in order to close the expected supply gap, the West European countries' gas dependency could exceed 50 percent in 1995.

Moscow has been actively pushing the sale of gas to a number of other countries on the periphery of Western Europe. Earlier this year, the Soviets concluded a series of new gas contracts with Finland (1.8 billion m^3/yr.) and Austria (1.5 billion m^3 yr.). In addition, they discussed gas exports with Sweden (1-2 billion m^3/yr.), Turkey (2-4 billion m^3/yr.), and Greece (1-2 billion m^3/yr.). Prime Minister Tikhonov also proposed the construction of a new export pipeline to deliver 21-22 billion m^3/yr. of additional gas to Eastern Europe after 1986. East European participation in construction of this pipeline would be patterned after the "Soyuz" pipeline from Orenburg in 1977-78, according to press reports.

Soviet long-term export policy could move in new directions, politically and economically, after 1990. If the USSR's oil supply becomes taut, gas sales will be pushed in an attempt to sustain hard currency revenues. Competitively priced gas sold to the West will most likely displace fuel oil in the household and industrial markets. Refineries will continue to use excess fuel

oil for refining feedstock and upgrading material, a practice that will lower demand for OPEC crude oil at the margin. Price competition for a few years might serve the Soviets' strategic interest, even though hard currency revenues would suffer temporarily. Cutting the price of gas would be a necessary first step if the Soviets aim to capture a vastly expanded share of the West European market. Many Western governments would welcome cheaper gas in order to reduce dependence on OPEC oil and possibly to stimulate economic activity with more sales of pipe and equipment.

The Soviets have the resources to mount an awesome natural-gas export offensive in the next decade. If the USSR obtains a much wider share of the market, Soviet gas could largely determine demand for other fuels. The USSR could then gradually exert political pressure on West European buyers who would lack alternative secure supplies of natural gas. Present pipeline capacity is being expanded in the Ukraine to exploit new market opportunities, and 1 or 2 new Czechoslovakian transit lines could be built in a year.

If Moscow moves quickly to preempt the West European market, it could delay or prevent development of more secure alternative energy supplies in the North Sea. Twenty years ago, the fear of Soviet oil flooding the West European market failed to materialize because the Soviets lacked the oil. This time, they have the gas and the potential ability to flood the market, unless Western strategic and political considerations prevent them from doing so.

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